

Franchise Tax Board**ANALYSIS OF ORIGINAL BILL**

Author: McLeod Analyst: Victoria Favorito Bill Number: SB 420
Related Bills: See Legislative History Telephone: 845-3825 Introduced Date: 2/21/2007
Attorney: Tommy Leung Sponsor: _____

SUBJECT: Business Expense Deduction/Authorize Workers' Compensation Self-Insured Groups To Elect Deduction For All Contributions Or Assessments Accrued Or Received During Taxable Year For Subsequent Years

SUMMARY

This bill would allow worker's compensation self-insured groups (SIGs) to make an election to deduct certain contributions and assessments.

PURPOSE OF THE BILL

According to the author's office, the purpose of this bill is to alleviate the eroding of funds as a result of taxing member contributions that have been earmarked for future payments to injured workers.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective immediately upon enactment and would be operative for taxable years beginning on or after January 1, 2007.

POSITION

Pending.

ANALYSIS**FEDERAL/STATE LAW**

Workers' compensation laws are designed to ensure that employees who are injured or disabled on the job are provided with fixed monetary awards, eliminating the need for litigation. These laws also provide benefits for dependents of those workers who are killed because of work-related accidents or illnesses. Some laws also protect employers and fellow workers by limiting the amount an injured employee can recover from an employer and by eliminating the liability of co-workers in most accidents. State workers' compensation statutes establish this framework for most employment.

Federal statutes are limited to federal employees or those workers employed in some significant aspect of interstate commerce.

Board Position:

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_____ SA	_____ O	_____ NAR
_____ N	_____ OUA	_____ <u>X</u> PENDING

Department Director**Date**

Selvi Stanislaus

7/23/07

Current state law requires all employers to purchase or provide workers' compensation benefits for their California employees. Employers may finance their liability for workers' compensation benefits by one of three methods: (1) self-insurance, (2) private insurance, or (3) state insurance. Employers wishing to self-insure must first obtain consent from the Department of Industrial Relations (DIR). Only certain aspects of workers' compensation are administered by a government agency.

Under DIR, the Office of Self Insurance Plans (SIP) authorizes qualified employers to provide their own coverage for workers' compensation liabilities. SIP is responsible for certification of public and private self-insured employers, third-party administrative agencies that oversee self-insurance programs, and individual claims' adjusters. Self-insurers are required to post a security deposit, which is adjusted annually to cover liabilities incurred.

In 1993, the Legislature authorized the establishment of private-industry SIGs intended to address employers' workers' compensation costs.

Under state law, two or more employers with the same industry code may form a nonprofit mutual benefit corporation for the purpose of self-insuring its workers' compensation coverage. As of January 16, 2007, there were 27 self-insured groups listed on the roster of the Office of Self-Insurance Plans.¹

The DIR adopted the following regulatory requirements for SIG formation:

- SIGs must maintain an aggregate net worth of \$5 million and average annual consolidated group net income greater than \$500,000.
- SIGs must have sufficient income to fund the following items:
 - Group self-insurer's actuarially projected claim liabilities at the 80% confidence level,
 - Expected payment of administrative expenses to operate the group self-insurer's business operations, and
 - Required security deposit.
- Group members must submit two years of audited financial statements and affiliate members must submit one year of reviewed financial statements.
- Members must agree to share risk jointly and severally.
- Members must undergo a feasibility study and submit an operating plan for approval by the state.

SIGs are created by employer members to help manage the payments of workers' compensation benefits in a timely, efficient, and cost-effective manner.

Federal tax treatment of SIGs

Under current federal law, SIGs are taxed the same as insurance companies. Gross premiums are reported as income and taxed at the corporate rate and SIGs are allowed a deduction on discounted unpaid losses. The practical effect of discounting spreads the deduction of incurred losses over a number of years to match investment earnings on losses incurred but not yet paid.

¹ <http://www.dir.ca.gov/SIP/GroupRoster.pdf>

State tax treatment for SIGs and its member employers

Members contribute into the fund and SIGs pay each policy year's expenses (administrative costs, claims, etc.) from collected funds. The contributions are comparable to the insurance premiums paid by insured employers to insurance companies.

In the event that member funds collected within any calendar year are insufficient, the SIGs will assess employer members for additional contributions to meet the funding requirements for workers' compensation.

Members will ordinarily treat contributions and assessments paid to SIGs as an expense that is deducted from each member's taxable income for the year in which it is paid or incurred. Excess contributions which are not required for reserves can be returned to the members as a dividend. A refund of excess contributions will be recognized as income for the year in which it is received or accrued.

For state purposes, SIGs are not taxed like other insurance companies under the gross premium tax. Instead, SIGs are subject to the corporate 8.84 % income or franchise tax.

Unlike the federal deduction, SIGs are allowed a deduction only on claim related losses incurred and paid for the taxable year; subsequent payments for the loss are taxed to the extent that the contributions are kept in the reserves.

THIS BILL

This bill would allow a SIG to make one of the following irrevocable elections:

- Deduct all contributions or assessments accrued or received during the taxable year from current income, or
- Deduct the losses, expenses, and dividends that are paid during the taxable year from contributed funds.

This bill would allow the Franchise Tax Board (FTB) to permit a SIG to reverse the election if the group can establish good cause for reversal and the DIR determines the revision is both in the best interest of the SIG and likely does not interfere with the ability of the group to timely and accurately fund the workers' compensation benefits for injured workers covered under the group.

IMPLEMENTATION CONSIDERATIONS

The department has identified the following implementation concerns. Department staff is available to work with the author's office to resolve these and other concerns that may be identified.

Under this bill, a SIG could make an election to deduct contributions and assessments accrued or received during the current taxable year and subsequently reverse this election if the group can establish good cause and the DIR determines the revision is in the best interest of the group.

Because a SIG may reverse the election at any time, FTB will be unable to determine the timing of the deduction without an audit.

This bill does not specify how the election would be made and when an election is terminated. For example, who will administer the election process and approval, validation, and termination? It is suggested that the election be made on a timely filed original return and be binding on the taxpayer for a specified term of years. This bill does not specify which agency the taxpayer should contact to request termination of the election. The author may consider requiring the taxpayer to notify DIR initially and submit to FTB all documents received from DIR supporting the termination of the election.

OTHER STATES' INFORMATION

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York*. These states were selected due to their similarities to California's economy, business entity types, and tax laws.

Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York have similar established groups to help employers secure funds and pay workers' compensation claims; however, these states tax similar self-insured groups as insurance companies subject to a gross premiums tax.

FISCAL IMPACT

This bill would not significantly impact the department's costs.

ECONOMIC IMPACT

Revenue Estimate

Based on data and assumptions discussed below, this provision would result in the following revenue losses.

Estimated Revenue Impact of SB 420 Operative for Tax Years BOA 1/1/2007 Assumed Enactment After 6/30/07		
2007/08	2008/09	2009/10
Footnote A	Footnote A	Footnote A

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this bill.

Footnote A: The revenue loss could potentially be in the tens of millions of dollars. See discussion below.

Tax Revenue Discussion

This bill would allow a deduction for contributions made to a SIG. The revenue impact is dependent on the amount of income taxes paid by SIGs and the classification of investment

income. If investment income earned on contributions is treated as a contribution paid by group members, all investment income would be reported as a deduction and not taxable. SIGs are currently taxed on contributions that exceed claim payments and operating expenses. Unused contributions of any year can be refunded to group members and are taxed as dividend income. The amount of taxes paid by group members on dividend income is unknown.

Based on a review of income tax returns for taxable year 2005, 27 SIGs paid slightly less than \$200,000 in taxes. A portion of this tax liability is associated with investment income received in preceding years. Under this bill, a deduction would be allowed for contributions, prospectively, in the year received. Therefore, the tax liability associated with investment income earned on assets from prior year contributions would still be paid in the first few years.

In addition to current tax liabilities, this bill would allow investment income to be classified as a contribution. If so, investment income would be deductible and exempt from taxation. This could lead to an income tax avoidance scheme. Because refunding excess contributions is optional, SIG members could deliberately over fund their insurance plans and forgo paying taxes on investment income.

The revenue loss would be exacerbated if taxpayers set up new SIGs for workers' compensation insurance as an alternative to paying premiums to insurance companies. Based on data provided within the DIR's 2005 annual report, revenue for the workers' compensation gross premiums tax exceeds \$300 million. Assuming that taxpayers set up new SIGs instead of making premium payments to insurance companies, revenue losses would total \$30 million from the resulting decrease of the 10% gross premiums tax paid by insurance companies. The combined revenue loss from forgone gross premium tax and the potential for tax avoidance through intentional over funding of a SIG is unknown but could total tens of millions of dollars.

ARGUMENTS/POLICY CONCERNS

The National Association of Insurance Commissioners and the California Department of Insurance requires insurance companies to establish loss reserves. SIGs have similar reserve requirements under state law. For federal income tax purposes, SIGs are taxed the same as insurance companies and are allowed deductions for loss reserves. California has no similar federal deduction. Under the California Constitution, California taxes "insurers" on gross premiums in lieu of the California corporation income and/or franchise tax. However, SIGs are treated as corporations and subject to the income or franchise tax. According to the author's staff, the intent of this bill is to provide SIGs with more favorable tax treatment similar to that allowed for insurance companies. However, by allowing SIGs to deduct all contributions and assessments received during the current taxable year, this bill would surpass the tax benefits offered to insurance companies

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